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CAPITALIZATION AND DISCOUNT RATES: MATHEMATICALLY RELATED, BUT CONCEPTUALLY DIFFERENT

Jim Rigby, CPA, ASA, and Michael J. Mattson, MBA

Inexperienced valuers often confuse the discount rate with the capitalization rate. Their confusion may result in a flawed valuation, and if the valuation has to be defended in court, they may suffer a tremendous loss of credibility. Conceptually, the two rates are quite different, yet they are linked mathematically.

DISCOUNT RATES

The discount rate, sometimes called the *cost of capital* or *the required rate of return,* is the total return the typical investor demands in order to invest in some asset or business. The premise behind using a discount rate is that the sum of money to be received has less value in the future than it has today. If the asset is risky, the investor may require a higher return to compensate for that risk. The discount rate includes components associated with—

▲ **A risk premium, an amount that accounts for the asset's risk.**

▲ **Expected inflation.**

▲ **Real return.** This component is usually quite small but necessary for an investor to give up an opportunity to use the money for something else.

The last two items, when combined, represent the risk free rate.

Most of the return demanded by investors in investment-quality bonds, which is captured in the bonds' yields, is inflation-related; the risk premium, if required, is small. The rates of return required of stocks of small companies, on the other hand, are composed mostly of a risk premium.

The average return on Treasury Bills (T-Bills) over the last 69 years has been about 3.7 percent, while inflation averaged about 3.1 percent, according to Ibbotson Associates, a publisher of information about public markets. Therefore, the inflation-adjusted return over this period (the "real" return component) was only 0.6 percent.

Historically, in an average year, the return on blue chip stocks is 8.4 percent more than the return on T-Bills, and small stocks outperform T-Bills by 13.7 percent. Thus, most of the return included in a discount rate for an equity investment is related to its risk.

CAPITALIZATION RATES

The capitalization rate is used to estimate the economic value of a business. The known or estimated income or cash flow from the business is capitalized at what is considered to be an appropriate rate of return on the investment, resulting in its value. The appropriate application of a capitalization rate is to divide it into the earnings or cash flows of a business or asset to arrive at an earnings multiple. The appraiser should determine what type of income should be capitalized—net operating income, dividend income, gross profit, cash flow, or some other "normal" income

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(excluding extraordinary income or expenses)—that will be used as a basis for predicting the amount of future income of the type selected. When investment bankers or business valuers discuss values, they usually do so in terms of earnings multiples. A business's earnings multiple is simply the reciprocal of its capitalization rate. It should be noted that technically the P/E ratio is related to earnings whereas the capitalization rate is related to cash flows. Over the long run, however, earnings and cash flows are virtually the same for most companies.

Perhaps the best known earnings multiple is the Price-to-Earnings (P/E) ratio. The relationship between a business's capitalization rate and its P/E ratio can be illustrated in the example of Company A, a closely held business. Its latest annual earnings were $300,000. Publicly-traded companies comparable to A have P/Es of 5. Based on these comparables, Company A's value is $1.5 million (5 x $300,000). Company A's capitalization rate, therefore, is 20 percent (0.20, which is the amount obtained by dividing $300,000 by the $1.5 million value).

RELATIONSHIP OF DISCOUNT RATES TO CAP RATES

Mathematically, the capitalization rate and the discount rate are closely related. The capitalization rate is equal to the discount rate less a rate of perpetual earnings or cash flow growth. This relationship comes from simplifying the standard present value formula:

$$\text{Value} = C_1(1+r)^1 + C_2(1+r)^2 + \ldots + C_n(1+r)^n + \ldots$$

to its mathematical equivalent:

$$\text{Value} = \frac{C_1}{(r-g)}$$

where:

C_1 is the cash flow or earnings for period 1; r is the discount rate expressed as a decimal (for example, 15 percent as 0.15); and g is the average annual growth rate of the C_1s into perpetuity, also expressed as a decimal (this assumes that the business is relatively stable).

Exhibit 1

Net Present Value of the Future Benefits

End of Year	*Future Benefit Stream*	*Present Value*
1	$100	$83
2	112	78
3	125	73
4	140	68
5	157	63
6	178	59
7	197	55
8	221	51
9	248	48
10	277	45
11	311	42
12	348	39
13	390	36
14	436	34
15	489	32
16	547	30
17	613	28
18	667	26
19	789	24
20	861	22
Terminal Value	$12,058	315
Total Value		$1,250

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Since the cap rate is the amount that must be divided into a business's earnings or cash flows to derive its value, the cap rate must be equal to r–g. It should be noted that the last equation, when used in a valuation context, is known as the *dividend discount model* or the *Gordon Growth Model* (GGM).

The GGM is used on a regular basis by valuers who use the build-up method to arrive at a capitalization rate. The typical build-up model is developed as follows:

	Risk Free Rate (RFR)
+	Expected Market Premium over RFR
+	Size Premium
+	Specific Company Adjustment
=	Discount Rate
–	Growth Rate
=	Capitalization Rate

In using the GGM, valuers need to fully understand the difference between discount rates and capitalization rates to avoid incorrectly using either rate and thereby creating material errors in the value indications.

Valuers may need to make some adjustments when translating a P/E ratio obtained from comparable public companies to a capitalization rate for a closely held company. They may need to add a control premium or a marketability discount.

Valuers also need to be aware of another issue related to P/Es: P/Es normally are a mix of an historical measurement of earnings with a market price that is prospective in nature (that is, it embodies the market's assessment of the company's future prospects). The capitalization rate is also a forward-looking concept. This apparent inconsistency, however, is usually not a major problem.

Two criteria that valuers need to consider in developing a capitalization rate are:

1. The rate should be consistent with the rate needed to attract investment in the valuation subject.

2. The rate should be consistent with the kind of income to be capitalized (that is, pretax earnings or after-tax earnings).

To valuers who are out of practice with algebra, mathematical presentations similar to those on page 2 always seem logical but often leave them without a sense of true understanding. Exhibit 1 demonstrates the GGM with a simple capitalization of the current cash flow or benefit stream. The example starts with a $100 benefit in year 1 and increases it by 12 percent per year forever. The initial $100 grows to $861 by the twentieth year.

The actual benefits and their present values are listed for each of the twenty years. The first column gives the actual, growing benefits: the "terminal value" (or "residual") is simply the present value of all benefits beyond the twentieth year. The second column shows the present values for each year and the residual using a 20 percent discount rate. In this example, the total present value of these future benefits is $1,250.

Using the right assumptions, the valuer should arrive at the same value for the company with both the discounted cash flow approach, in which each year's cash flow is discounted by the appropriate rate of return, and the capitalization of earnings method (a single point method). The equivalency is demonstrated when the capitalization rate is computed using the assumptions in the example.

The capitalization rate is computed as:

Discount Rate	20%
Less Growth Rate	12%
Capitalization Rate	8%

Testing the capitalization rate with the current benefit stream should provide the same $1,250 value indication:

Benefit ÷ Capitalization Rate = Value Indication

$100 ÷ 0.08 = $1,250

As can be seen, the discounted future benefits and the capitalization of earnings methods provide identical value indications under ideal conditions (which include the fact that short-term and long-term expected growth rates in earnings are the same). Although no CPA has a crystal ball to perfectly predict the future streams or long-term growth rates, the valuer can use some basic guidelines.

Using the GGM as a guide, valuers should follow three basic guidelines in performing valuations:

1. In a growing business with a growing benefits stream, the capitalization rate will be smaller than the discount rate.

2. In a mature business with a flat benefits stream that will keep pace only with inflation, the capitalization rate should be equal to the discount rate less inflation.

3. In a declining business with a declining benefits stream, the capitalization rate should be greater than the discount rate. CE

Valuers need to fully understand the difference between discount rates and capitalization rates to avoid incorrectly using either rate and thereby creating material errors in the value indications.

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EMPLOYEE THEFT INVESTIGATIONS

Roger L. Wayman, CPA

Investigation of employee theft may well be one of the growth industries of the future. The theft of employers' assets by an employee can take many forms. The most common employee thefts involve the manipulation of accounting records. Because knowledge of accounting and auditing practices is needed to understand many of the facts, CPAs are often called upon by the insurance company, or the insured, to investigate.

If an employer is covered by a fidelity bond, usually a claim for the loss will be filed with the insurance company. A fidelity bond covers only those losses caused by employee theft or dishonesty and not normal losses incurred by the insured, such as accidental damages or loss of a shipment. (See "Forensic Accounting: Fidelity Coverage for Employee Theft," *CPA Management Consultant* (Winter 1995). Theft losses are more likely to be recovered if CPAs and other investigators are called in before the employee suspected of theft is confronted. Usually, however, they are called in after the confrontation. Nevertheless, skilled investigators can uncover the details of the theft to help the employer, the adjustor, and possibly legal counsel in determining the outcome of the case.

An engagement to investigate employee theft usually involves the following activities:

1. Identification of the perpetrator. Although the perpetrator may already have been identified, the CPA usually verifies that the facts and documents of the case are consistent with the identification.

2. Identification of possible conspirators. If evidence suggests possible collusion between employees, this possibility must be investigated.

3. Documentation of the loss. The parties may want copies of the documents involved in the theft. The documents may include checks, accounting journals, invoices, and other internal and external financial documents.

4. Determination of the dollar value of the loss. Even though the amount of the loss may exceed the amount covered by the fidelity bond, all parties will want to know the full amount of the theft by all methods used.

The CPA may also investigate other aspects of the alleged theft, including:

▲ **Determination of whether outside agencies were negligent or contributed to the loss.** The outside agencies may include vendors, subcontractors, or bankers who process fraudulent documents.

▲ **Analysis of theft methods.** Once successful in using one method of theft, employee thieves often use other methods. Therefore, the CPA needs to investigate beyond the known and documented methods. The CPA investigates all procedures that were previously performed by the suspected employee, compares them with current procedures, and documents any discrepancies.

▲ **Analysis of internal controls.** This analysis should result in the identification of the internal controls that were violated for each portion of the theft. The CPA determines whether the internal control simply is lacking or was circumvented by the employee.

THE INVESTIGATION

At the beginning of the investigation, the client should assign a key contact to the CPA. The contact should be familiar with the details of the theft and the location of the necessary records and should have the authority to provide the CPA with any information or records needed. Since confidentiality is usually a major issue in these situations, the key contact may be the only person with whom the CPA can freely discuss details of the loss. The CPA is careful to maintain this confidentiality when in contact with other employees to avoid risking a lawsuit for defamation of character.

DETERMINING THE LOSS

After establishing that a loss covered by the bond did occur, the CPA will usually calculate the loss. The CPA will need to conduct a careful review of the circumstances leading to discovery of the loss and the method used to calculate the amount of the loss claimed. It may become apparent that the method used to determine the loss is actually a method of concealment rather than a quantification of the actual theft. For example, a claim based on apparently open accounts receivable that actually have been paid. The open receivables may be due partly to the concealment of the misappropriation of payments received through such means as lapping and partly to other reasons not related to theft.

If accounting records related to the theft are missing, the CPA may need to develop alternate procedures to gain information that would have been available in these records. It is usually possible to get bank copies of deposits and checks, but this procedure is costly and must be done very judiciously. Bank reconciliations may be missing, but they can be recreated from available bank documents or from entries on bank statements. Since so many accounting records are interrelated, it may be possible to develop missing information from records other than the missing originals.

INTERNAL CONTROL

Frequently the CPA investigator needs to identify the ways in which internal controls were circumvented. Some common ways that controls may be circumvented include the following:

▲ The check signer is supposed to examine supporting documents such as invoices or evidence of the receipt of the goods and services before payment, but instead issues checks without these supporting documents

▲ An employee other than the bookkeeper reconciles the bank accounts, but fails to notice or report suspicious items.

▲ An authorized check signer signs checks that are fraudulently made out to an employee.

▲ An employee assigned to receive and record incoming cash also deposits the cash.

▲ An employee circumvents the payroll authorization process to issue duplicate checks to themselves or another employee.

In these instances, controls that were established were not followed and the CPA needs to investigate how this was allowed to happen.

The CPA will find it useful to become familiar with the handwriting of the various employees involved in the accounting process. In this way, the CPA may discover instances when employees' handwriting is

Reporting on Fraud Investigations

The following excerpts are from a soon-to-be-published AICPA Consulting Services Practice Aid on fraud investigation. Members of the AICPA's Management Consulting Services Membership Section automatically receive all practice aids as a member benefit.

The CPA's findings can be communicated by a variety of oral or written means, and these are discussed in more detail in the soon-to-be published Consulting Services Practice Aid 96-3, *Communications in Litigation Services: Written Reports.*

Written Communications: The CPA may be asked or required to communicate the engagement findings in writing. Although the Statement on Standards for Consulting Services (SSCS) No. 1 requires that the CPA communicate with the client, it does not require a written report, and no consulting standards exist that require a written report. The information contained within a report may vary depending on the client needs, advice of counsel, the CPA's preference or style, and the nature of the engagement. When the matter is subject to the Federal Rules of Civil Procedure, the CPA should determine if the relevant district of the U.S. District Court has implemented or amended the requirement for expert written reports. The CPA should also ascertain whether any similar requirements exist in relevant state or local courts.

Like other litigation consulting reports, written communications about fraud investigation findings can take a variety of forms, including brief letters, memorandums, affidavits, declarations, and detailed reports. In any form, a written communication may describe the work performed and state the findings, and be accompanied by detailed schedules, exhibits, other work product, or copies of specific documents. If the CPA is designated as an expert witness, the written report may be subject to discovery by the opposing party. Therefore, before preparing the discoverable writing or any other writing, the CPA might discuss with the client or the CPA's attorney the need for the writing, as well as the format, style, and content.

Specific items for a written report of a fraud investigation, in addition to those potentially applicable to any litigation services writing, might include a statement of the predication as the basis for the investigation, a list of interviews conducted, and a summary of interview information obtained. The report should avoid conclusions about the existence or absence of fraud, but should relate the procedures performed and the factual findings. Rarely should there be any assurance or guarantees of completeness.

In insurance related investigations, a CPA can help document fraud losses through a written communication commonly referred to as a *proof of loss.* The proof of loss is issued to insurance carriers, and summarizes the results of the investigation and the estimated loss amount. It also contains supporting calculations and relevant data and is examined by the insurance company. The insurance company can ask the insured to provide further proof of its claim. When disputes arise between the insurance company and the insured, the CPA may assist in resolving the disagreement or provide expert witness testimony.

Oral Communications: Oral communications generally occur throughout an engagement whether or not the CPA prepares any written communication. The CPA normally presents oral statements about the fraud investigation privately to the client, but he or she may also present them in a deposition, a courtroom, or another dispute resolution forum, or before an administrative or regulatory body. As an expert witness, the CPA may give oral testimony as an adjunct to a written investigative report or without an accompanying writing. Criminal prosecutions generally restrict pre-trial discovery concerning experts, so many criminal defense attorneys, in particular, do not ask the CPA fraud investigator to prepare a comprehensive written report. Instead, they seem to prefer only oral testimony that is supported by demonstrative evidence and the CPA's working papers. The CPA must support any oral expressions of findings or expert opinions with sufficient relevant data. Furthermore, the CPA's oral statements should be sensitive to the same legal liability exposures as a written report.

The investigation of employee theft and fraud requires creativity, combined with in-depth knowledge of accounting and auditing procedures.

on records to which they are not supposed to have access. This familiarity will help in determining exactly what parts employees may have played in the overall process that led to the loss.

TRACING TRANSACTIONS

The actual work in the investigation will largely involve tracing the recording of the fraudulent transactions. Once the CPA has established a pattern, it is necessary to determine how many transactions of a particular type were recorded. As the CPA traces the transactions, he or she will need to keep detailed notes and prepare schedules of the transactions to explain and illustrate the process later. These work papers will form the basis of the CPA's findings and conclusions and provide the documentation for a report.

Some fraud schemes are very elaborate, and tracing them may be very time consuming. The CPA needs to use judgment to determine just how far to go. Once a pattern has been established, it may be possible to make estimates or projections based on the types and numbers of transactions being traced. This approach will be most useful when numerous small transactions are involved. When large checks or transactions in significant amounts are involved, it is necessary to document these much more thoroughly.

THE REPORT

If litigation is in progress or is being considered, the CPA's first report will probably be an oral report directly to the attorney. Even though the report is oral, it will be necessary to supplement the information with the various schedules and notes prepared during the investigation. The attorney may ask the CPA's opinions about the identification of the perpetrator, the amount of the loss, and the thoroughness of the documentation of the proof. Other issues of interest to the attorney may include the identification of conspirators and possible negligence by other parties.

If the investigation is pre-litigation and is being done for an insurance company, a written report will probably be requested. Although each practitioner will develop his or her own style of reporting, certain common elements should be included:

1. Details of the assignment. This should set forth all the activities that the CPA was requested to perform.

2. Details of the loss claimed. This should list all the elements claimed in the initial proof of loss.

3. A list of all the records examined. This listing may include explanation of the reasons a particular record was examined and its relationship to the overall loss.

4. Details of the tests performed. Included with these details should be the reasoning behind the performance of each test.

5. Identification of the problems encountered. This section discusses the tests that were not performed because of missing records or circumstances beyond the CPA's control. The CPA might also suggest alternate sources of information or ways of getting around some of the problems encountered.

6. The answers to the assigned questions. This should set forth in the same order used at the beginning of the report, the answers to each question posed and each detail assigned to the CPA in the initial investigation.

7. Opinions of the amount of loss. If the CPA has been unable to determine an amount, he or she will want to explain why. If the CPA has concluded that no loss has actually occurred or that the records provided were insufficient to prove the loss, he or she should state this also.

The CPA should take the same care in reporting on fraud investigation as in any report provided in a litigation services engagement. Further discussion of reporting on fraud investigation is provided in the sidebar on page 5.

The investigation of employee theft and fraud requires creativity, combined with in-depth knowledge of accounting and auditing procedures. Although many methods of theft are simple and straightforward, the CPA may also be challenged to untangle extremely complicated, convoluted transactions. The practice area of fraud investigation not only is financially rewarding, but also challenges the CPA's analytical skills. CE

Award of Excellence

CPA Expert received an APEX'96 Award for Publication Excellence.

MCS Monitor

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November 1996

AICPA COUNCIL APPROVES BUSINESS VALUATION ACCREDITATION

AICPA Council approved the petition by the Board of Directors to create an accreditation program in business valuation. To earn the *Accredited in Business Valuation (ABV)* designation, a candidate must take a written examination. Eligibility to sit for the written examination requires that the candidate—

▲ Be a member in good standing of the AICPA and hold an unrevoked CPA certificate or license issued by a recognized state authority.

▲ Provide evidence of ten business valuation engagements that demonstrate substantial experience and competence.

To maintain the accreditation each credential holder shall—

▲ At the conclusion of every three-year period submit documentation demonstrating substantial involvement in five business valuation engagements.

▲ Complete sixty hours of related CPE during the same three-year period.

IMPLEMENTATION OF THE PROGRAM

The next step in the process of implementing the ABV accreditation program is to create an Examinations Committee to work with the Examinations Division in managing the preparation, grading, and administration of the written examination. An ABV Credential Committee will be created to administer and promote the ABV program. The Committee will be responsible for establishing the guidelines for evaluating candidates' and credential holders' documented experience. Both committees will consist of members in public practice as well as members in business and industry, government, and education.

PREPARATION FOR THE EXAMINATION

The first examination is expected to be administered in Fall 1997. Candidates should expect that practical experience will be needed to pass the exam. Several programs are available to reinforce candidates' basic understanding of fundamental valuation concepts and theory. One such program is the eight-module, 64-hour curriculum contained in the Business Valuation Certificate of Educational Achievement (CEA) program. The program covers all the key aspects of business valuation from basic theory and practice to data research and report writing. An advanced level CEA program will be available in mid-1997.

PROGRAM APPROVAL PROCESS

The approval to begin the development of the ABV designation was the culmination of a year-long effort by the AICPA Management Consulting Services Team to gain support of the Board and Council in conformity with the framework Council established in 1994 for all proposed accreditation programs.

The proposal was exposed to the membership through a survey. The majority of survey respondents favored the program, although some expressed concerns about the experience requirement measured in hours to earn and maintain the credential. The Board considered the issue of experience and agreed that although there was justification for the elimination of hours, there should still be criteria for experience consistent with Council's mandate to ensure that only those with experience and competence in the discipline earn the designation. The Board also recognized that, at the same time, in certain markets there will be an uneven—or cyclical—demand for the service. In response to the concerns of the membership, the Board recommended an alternative approach to meeting the experience requirement to Council as part of the overall petition.

SOME FREQUENTLY ASKED QUESTIONS ABOUT THE ABV ACCREDITATION PROGRAM

Q: *Is there a requirement for the submission of a work product ?*
A: At the present time, there will be no requirement that a work product be submitted.

Q: *Will there be a "grandfathering" provision for individuals who meet the qualifications to sit for the ABV examination and who possess credentials from other appraisal organizations?*
A: No grandfathering provision is envisioned. Candidates must meet the specific requirements of the AICPA accreditation program established by Council.

Q: *What is meant by "substantial involvement" in a business valuation engagement?*
A: The criteria will be established by the ABV Credential Committee, which will be created as a result of Council's approval of the proposed ABV program. Experience can be achieved, for example, through field work, report review, or expert testimony.

Q: *Who will determine whether the evidence of substantial involvement meets the experience requirement?*
A: The ABV Credential Committee will establish the rules and procedures for acquiring the credential in compliance with the requirements set by Council.

Q: *There are currently no AICPA standards for business valuation. Will any be created?*
A: Although no AICPA standards exist specifically for business valuation, relevant standards exist that are applicable to consulting services, accounting and review services, and prospective financial information. In addition, the AICPA Code of Professional Conduct requires the CPA to be competent to provide any service. Nevertheless, additional standards specific to business valuation will be needed. This issue of standards will be examined in the course of the implementation of the program.

Q: *I took the CEA program's eight modules with an examination after each one. Why do I need to take another exam when the CEA program should provide for an accreditation?*
A: The CEA program is a CPE program, which does not confer a credential. The CEA module exams are not envisioned to be the ABV accreditation exam. The purpose of the CEA program is to provide practitioners with a broad view of business valuation theory while the accreditation exam will focus on practical real-world application of this theory. Only those with experience in business valuations will be able to challenge the accreditation exam successfully.

WHY THE AICPA IS DEVELOPING AN ABV PROGRAM

Business valuation is a growth niche for CPAs, according to a recent survey of CPA consultants conducted by the AICPA Management Consulting Services Section. This discipline builds on the core competencies of CPAs, and the Institute supports practitioners who wish to develop the skills required to build a practice niche in business valuation by offering a CEA program, along with conferences, CPE self-study courses, and other publications.

Why should practitioners pursue the ABV designation rather than one offered by other organizations? The Institute recognizes the importance of the growth of business valuation as a practice niche. The market for business valuation services is served by many non-CPAs, and some organizations offering credentials in business valuation target a broad constituency that is not required to comply with the same standards as CPAs and may not have the core competencies of CPAs. Using the standards and core competencies as a foundation, the Institute is fully committed to providing the necessary resources and technical guidance that will allow CPAs to position themselves as leading providers of business valuation services. Furthermore, if the Institute does not commit to offering CPAs support in this area, it will be abdicating its self-regulating responsibility by allowing other organizations to take the lead in regulating the provision of business valuation services.

Any AICPA member interested in being added to a mailing list to receive ABV program information when it becomes available should dial 201-938-3787 from a fax machine, follow the voice cues, and select document no. 491.

December 1996

Dear *CPA Expert* subscriber:

Most surveys inquiring about the fastest growing areas in consulting services provided by CPAs indicate that business valuation is at or near the top. A 1995 survey of AICPA MCS Section members disclosed that two of every three CPAs believe that during the next five years business valuation will provide the greatest growth potential for their own firms, while more than three-fourths of the CPAs believe that business valuation will offer exceptional growth potential for the profession as a whole. The growth in this area is further evidenced by the recent AICPA Council approval of the proposal for an accreditation in business valuation.

In response to this data and in keeping with our ongoing efforts to bring to your attention products that may be useful to your practice, the MCS Membership Section, through Irwin Professional Publishing, is offering a special deal on two books to use in providing business valuation services to your clients. A description of both books is on the other side of this page.

The *Valuing a Business: The Analysis and Appraisal of Closely Held Companies (1996 edition)* and *Valuing Small Businesses and Professional Practices (1993 edition)* cover the depth and breadth of theory and principles in valuing small business entities of various types for a number of purposes that today's CPAs regularly encounter.

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Sincerely,

Steven E. Sacks, CPA
Management Consulting Services Membership Section

EXPERT Opinion

BIG THINGS COME IN SMALL PACKAGES

Small Case Deals With Major Value Issues

James R. Hitchner, CPA

We've all heard the saying that big things come in small packages. This could not be truer than in the gift tax case *Jane O. Kosman v. Commissioner of Internal Revenue* (T.C. Memo. 1996-112). The case is small in that the gift tax deficiencies determined by the IRS totalled less than $175,000. Despite the smallness of the case, it dealt with several major issues, and in dealing with them demonstrated several emerging or continuing trends in the Tax Court's views of estate and gift tax valuations.

The valuation issues addressed by the Court included:

1. The application and amount of discounts.

2. The use of multitiered or layered discounts.

3. The proper use of guideline public companies.

4. The application of prior transactions in setting the company's stock value.

5. The acceptance of discounted-cash-flow (DCF) valuation methods. The case dealt with the fair market value of gifts of stock in Kosman, Inc., a bank holding company, as of September 30, 1986 and March 31, 1987. Kosman, Inc. owned a 32 percent minority interest in Scottsbluff National Corp., which owned 100 percent of Scottsbluff National Bank (SNB). Kosman, Inc. also owned a 10 percent minority interest in Western National Bank (WNB). The various minority gifts in Kosman, Inc. were of voting and nonvoting stock. The Court's opinion of value for the stock gifts were 41 percent to 55 percent higher than the taxpayer's opinion of value (see the table on page 8).

APPLICATION AND AMOUNT OF DISCOUNTS

The Court accepted a 10 percent minority interest discount at the holding company level because both the IRS and taxpayer experts chose the same figure. (The IRS retained three outside experts to present its position. The taxpayer retained experts from a national accounting firm to develop the valuation.)

The basis for the taxpayer's expert's 25 percent discount for lack of marketability was a study conducted in 1971 by the Securities and Exchange Commission (SEC) of restricted stock sales of over-the-counter companies. The taxpayer's expert also cited an article that appeared in *The Wall Street Journal* in 1994 which discussed an SEC regulation requiring foreign investors to hold shares they buy from public companies for forty days before they can sell the shares in the U.S. The Court dismissed the taxpayer's expert's presentation of the foreign investors because "...petitioner did not show that the corporations in the article were comparable to Western National Bank or that a forty-day restriction applies."

The IRS's experts applied a 10 percent discount for lack of marketability at the holding company level based on a study prepared by another appraisal firm, which they interpreted to indicate that companies with earnings over $1 million had discounts ranging from 10 percent to 20 percent. The IRS experts choice of the 10 percent discount for lack of marketability at the holding company level was also influenced by the fact that the experts applied discounts to the underlying ownership interests in the two banks. The Court opined that a 15 percent discount was appropriate.

Although the 1971 SEC study of restricted stock sales is still relevant, many more recent studies, even as of the valuation dates here, could have been relied upon in choosing discounts. Practitioners also need to keep in mind that the Courts expect valuers to provide detailed analysis and comparisons of the company being valued and its attributes concerning marketability when using the various studies. This trend was clear in the recent gift tax case *Bernard Mandelbaum et al. v. Commissioner* (T.C. Memo. 1995-25). (See "Expert Opinion: Tax Court Reviews Nine Factors for Selecting Marketability Discounts," *CPA Expert,* Winter 1996).

The Court allowed a 4 percent discount for the nonvoting common shares. The Court felt the taxpayer's expert did an inadequate job in supporting a 10 percent discount. The IRS experts applied a 4 percent discount based on a study published in the April, 1983 issue of *Journal of Financial Economics* entitled "The Market Value of

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Again, the Court went with the expert who did his homework and had the better presentation.

Control in Publicly Traded Corporations." This study evaluated the difference between publicly traded corporations that had voting and nonvoting shares. The study showed that premiums for voting rights usually range from 2 percent to 4 percent. Here again, the Court went with the expert who did his homework and had the better presentation.

MULTITIERED DISCOUNTS

The IRS's experts applied a 15 percent minority interest discount and a 10 percent discount for lack of marketability to the holding company's 32 percent minority interest in SNB. They applied a 20 percent minority interest discount and a 15 percent discount for lack of marketability to the holding company's 10 percent minority interest in WNB.

To determine the fair market value of the holding company interest, the IRS's experts applied an additional 10 percent minority interest discount, a 10 percent discount for lack of marketability, and a 4 percent discount for the nonvoting stock. These multitiered or layered discounts were apparently considered by the Court in the valuation of SNB and accepted by the Court in the valuation of WNB.

This is a classic example of the valuation of a minority interest in a company that holds minority interests in other companies. It is refreshing to see the Tax Court address this issue and accept the use of multitiered discounts, an approach that many valuation practitioners have taken in recent years. This could also lend support for the use of multitiered discounts in family limited partnerships that hold minority interest in closely held companies where two levels of discounts are often applied.

PROPER USE OF GUIDELINE PUBLIC COMPANIES

The taxpayer's expert relied upon one in-state (Nebraska) public bank and rejected several others because of differences in size, geographical diversity, and loan portfolio. The IRS's experts applied the valuation multiples of several out-of-state banks. The Court found inconsistencies in the IRS's experts' use of public company multiples and also opined that "Respondent's experts did not adequately address whether economic conditions in those bank markets and in northwestern Nebraska were similar."

Fair Market Value Per Share (Rounded)

	IRS	Taxpayer	Court
9-30-86			
Voting Shares	$294	$116	$165
Nonvoting Shares	282	101	156
3-31-87			
Voting Shares	294	132	186
Nonvoting Shares	282	114	176
Discounts (Holding Company Level)			
Minority Interest	10%	10%	10%
Lack of Marketability	10%	25%	15%
Nonvoting Stock	4%	10%	4%

This opinion continues the trend in the Tax Court concerning the use of guideline public companies. The Court expects valuation experts to make a detailed presentation as to the comparability of guideline public companies and to be ready to explain both similarities and differences between the public companies and the company being valued. Some valuers continue to use alternate industries when they cannot find good guideline public companies within the subject company's industry. It appears, however, that the Court very often disagrees with this approach.

APPLICABILITY OF PRIOR TRANSACTIONS IN SETTING STOCK VALUE

The Court did not accept the reliance upon sales of company stock because "With one exception, the sales on which respondent relies involved former employees, directors, or their families. The shareholders received higher prices for their shares because of their association with the corporation."

The Court's comment underscores the importance of using transactions in the company's stock that are considered arm's length. However, I believe it is inappropriate to reject these transactions just because they involve former employees, directors, or their families. I agree that the burden of proof is greater in these transactions. However, I have seen actual arm's length transactions among such parties, especially when the interests are adverse.

ACCEPTANCE OF DISCOUNTED CASH FLOW VALUATION METHODS

The Court accepted the discounted cash flow (DCF) presented by the IRS's experts and felt it was more applicable than their capitalization of earnings method. However, the Court felt that their discount rate or rate of return was too low because they failed to realistically assess the economic outlook for the bank.

In several recent cases, the Tax Court accepted DCF methods. In *Estate of Mildred Herschede Jung* (101 T.C. No. 28, 1993), both the IRS and the taxpayer's experts used DCF methods. The Court also opined that the DCF method was more reliable than the market approach. Furthermore, in *Estate of Ray A. Ford* (T.C. Memo. 1993-580), the IRS's expert used a DCF method, and in *Lewis G. Hutchens* (T.C. Memo. 1993-600), both the IRS's and taxpayer's experts used DCF methods.

CONCLUSION

This case continues several emerging trends in estate and gift tax valuations: The IRS is hiring experienced and qualified experts. The Tax Courts are accepting DCF methods and questioning the public company market approach when they think the public companies lack comparability.

In this instance, the Court also accepted multitiered or layered discounts. They accepted discounts for the minority interest that the holding company had in two banks. They then accepted discounts for the minority interest in the holding company that were the subject of the stock gifts. This may be why the holding company discounts appear so low. CE

TIPs of the Issue

AVOIDING THE RISKS COMMON IN COMPLEX LITIGATION SERVICES ENGAGEMENTS

Melinda M. Harper, CPA

The outcome of *Sanchez v. KPMG Peat Marwick* reinforces the importance of good communications among counsel and the various participants in the case. In this case, the plaintiff, Robert Sanchez sued KPMG Peat Marwick for $17 million in connection with the bankruptcy of a chain of drug stores he owned, Every Day Discount Drugs, Inc. (EDDI). In 1989, EDDI entered into a stock swap agreement, under which it exchanged capital stock with Summa Medical Corp. Sanchez alleged that EDDI was unable to subsequently sell the Summa shares because Summa's chairman had violated federal security laws by selling restricted Summa shares in transactions disguised as loans. Sanchez alleged that he was defrauded in the transaction because Peat, the auditor for both companies, failed to disclose the alleged illegal loan transactions.

The plaintiff's experts in the case included a CPA, who in his expert's report and sworn testimony given in depositions, said that Peat committed professional malpractice. According to the CPA expert, the loan transactions were illegal and KPMG should have so informed Sanchez before he agreed to the stock swap.

The judge disallowed the CPA's expert testimony. The judge's decision may have been influenced by the fact that an expert in securities law on the same side as the CPA contradicted the CPA's testimony. Specifically, the CPA expert expressed an opinion about a matter for which a legal opinion was appropriate.

Several risk factors were present in the *Sanchez* case: multiple attorneys, multiple defendants, and multiple experts, along with expert opinions that, at minimum, appeared to overlap with other areas of expertise. These risk factors, which are common to complex litigation, can result in apparently contradictory positions or gaps in support for positions, and the outcome can be detrimental for the experts and attorneys as well as the litigants.

The outcome of the case may or may not have been different had several risk factors not been present (see "Expert Opinion: Federal Judge Disallows Expert Testimony," *CPA Expert*, Summer 1996). Perhaps, however, the contradictory testimony could have been avoided with good communication and coordination among the attorneys and experts. CE

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ARE YOU SURE YOU'RE LICENSED TO TESTIFY?

Andrew D. Finger, CPA, and Edward J. O Grady, CPA

When a CPA testifies in a state other than those in which he or she is licensed, an important consideration is whether the CPA needs to be licensed in that state to provide this professional service. Some state accountancy laws exempt incidental practice, others require the CPA to obtain a renewable temporary license, and some do not permit the CPA to testify without a permanent license.

In some states, the simple act of appearing in court requires the CPA to obtain a license. Some states, however, provide an exemption for testifying when all the work is done outside the state. Accountancy laws in some states do not cover expert witness testimony because they consider the practitioner's status as expert to be based on the individual's business experience rather than the CPA certificate itself.

The CPA who does not meet the requirements risks being disqualified by the court and unable to testify. A further risk if this happens is that the CPA will be sued by the client for the costs he or she incurred for the client in preparing to give testimony.

Most statutes are not clear enough to enable the CPA to easily determine whether a license or experience is needed. In addition, still unresolved in some federal jurisdictions is the issue of testifying in a federal court located in a state other than the one in which the CPA is licensed.

The safest way to determine what kind of licensing is required is to request in writing a determination from the state accountancy board or licensing department. These agencies are willing to respond to telephone inquiries. Sometimes, however, individuals responding to the inquiry lack the knowledge needed to answer the query accurately and reliably. A written request that includes sufficient information for the reader to determine that a license is or is not necessary is the safest way to practice. CE

AN IMPORTANT REMINDER: IRS ACCEPTS VALUE REDUCTION FOR BUILT-IN CORPORATE CAPITAL GAINS TAX LIABILITY

James R. Hitchner, CPA

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In the last few years, a subject of considerable debate has been the applicability of a discount that would reflect potential liability for corporate capital gains tax. Often, corporate assets such as real estate and securities are economic time bombs that are triggered when these appreciated assets are sold.

Recent court cases have generally held that the valuer of companies with such assets cannot use a discount for the capital gains tax liability when the likelihood of liquidation of the assets is speculative. In *Estate of Luton et al. v. Commissioner* (T.C. Memo. 1994-539), for example, the Court said "this Court has consistently held that a discount for potential capital gains tax at the corporate level is unwarranted where there is not evidence that (1) a liquidation of the corporation was planned, or (2) the liquidation could not have been accomplished without incurring a capital gains tax at the corporate level." (See "Expert Opinion: Court Continues to Select Values Based Upon Appraisal Merit," *CPA Expert,* Premier issue.)

In *Estate of Stewart B. Kett,* T.C. Docket No. 1742-94, however, the IRS chose to settle the case, which was scheduled for trial on February 13, 1995. The major issue in the case was capital gains tax liability The settlement was based upon a 40 percent discount from C corporation net asset value in real estate holding companies in which the decedent owned 100 percent of the outstanding stock. This appears to be a pivotal win for the taxpayer in supporting significant discounts for the capital gains tax liability, which is sometimes referred to as the general utilities repeal valuation discount. Knowledge of this case may help practitioners and their clients in negotiations concerning this issue. CE

DOES THE IRS RECOGNIZE *DE FACTO* COMMON LAW MARRIAGES?

George R. Weber, CPA

The IRS recognizes a common law marriage as a marriage for tax purposes (Revenue Ruling 58-66, 1958-1 CB 60). The purposes include establishing the nontaxable status of property settlements in a marital dissolution. In states that do not have common law, however, a question arises as to the tax status of dissolutions of unmarried couples under domestic partnership provisions.

Oregon, for example, treats domestic partnerships of unmarried persons as legal and provides for property settlements on dissolutions under procedures in the courts similar to those for marital dissolutions. The question for practitioners to raise is whether the IRS would consider such procedures as *de facto* common law dissolutions that qualify for treatment as marital dissolutions for tax purposes. As a precaution, practitioners in states without common law need to avoid assuming that unmarried partnerships will be treated as married partnerships. Instead, they should check with the state tax authority to determine if it follows Revenue Ruling 58-66. In addition, they may need to request a ruling on the issue from the IRS. CE

George R. Weber, CPA, practices in Portland, Oregon.

FYI...

Business Valuer Qualification Criteria. After reviewing the qualification criteria for designations in business appraisal organizations, the Appraisal Qualification Board (AQB) decided that it will not develop criteria for business valuers at the present time. The AQB plans to review the issue again in late 1997. The AQB is an independent board that establishes criteria for licensing, certification, and recertification of appraisers. It is part of The Appraisal Foundation, a not-for-profit educational organization that operates to foster professionalism in appraisal work. The AQB acknowledges the efforts of business appraisal organizations to promote professionalism by establishing designation criteria and encourages them to adopt Uniform Standards of Professional Appraisal Practice (USPAP) as minimum business valuation standards. USPAP deals with the procedures to be followed in performing an appraisal, review, or consulting service and the manner in which the procedures are to be communicated.

IRS Guidance on Physician Valuation. The IRS issued its *Continuing Professional Education (CPE)* textbook for 1996, which is used to train IRS agents. In response to the impact that managed care has had on health care providers, the textbook provides guidance on medical practice acquisition and valuation. Chapter Q of the textbook provides a detailed discussion of the valuation of medical practices acquired by tax-exempt hospitals and integrated delivery systems. Valuers are advised to use each of the three standard approaches to value a practice:

- The cost approach to value certain tangible assets (for example, medical equipment, furniture, and fixtures) and certain intangible assets (for example, medical records, assembled work force, and computer software).
- The market approach to value other tangible assets (for example, real estate).
- The income approach to value other intangible assets (for example, covenants not to compete, contracts, trade names, and favorable leases).

For more information about the textbook, see "IRS Offers Guidance on Physician Practice Valuation," *Healthcare Financial Management* (June 1996): 32-34.

Marketing Litigation Services. What is a good way to market litigation support services? That question was asked of Dana Beal, a Spokane-based consultant specializing in motivational sales training, at the annual conference of the Association for Accounting Marketing in San Diego. Beal replied: "As a consultant, I work with accountants and attorneys, and I see litigation services as another of those untapped potentials out there because attorneys like to win cases. If you have a good litigation services specialist or several and they prove themselves, they can be a very lucrative source of business. It's highly billable and easy to market. The way to market is just get the information out there. Get it known in the community. Some of the ways I've seen be very successful are taking attorneys to lunch and sending a newsletter to keep them informed. A lot of times just going to places where attorneys are and talking to them about their cases produces leads. Many times attorneys haven't thought of using an expert witness. The idea that they could use one to benefit them and help win the case can come as a surprise sometimes, and they will actually get into the habit of using more litigation services specialists." (Reprinted with permission of the Association for Accounting Marketing, Denver.)

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